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VIA MAIL AND EMAIL

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
P.O. Box 2319
26th Floor
2300 Yonge Street
Toronto, ON
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Dear Ms. Walli:

Re: The Cost of Capital in Current Economic and Financial Conditions EB-2008-0084

Comments of the Vulnerable Energy Consumers Coalition (VECC)

As Counsel to the Vulnerable Energy Consumer's Coalition (VECC), I am writing, per the Board's letter of March 16, 2009 to provide VECC's comments on the questions the Board has raised with respect to the Cost of Capital parameters established for 2009 in regards to Electricity Distributor rate rebasing applications. VECC's comments are set out below and organized according to the Board's five questions.

<u>Question #1:</u> How do the current economic and financial conditions affect the variables (i.e., Government of Canada and Corporate Bond yields, bankers' acceptance rate, etc.) used by the Board's cost of capital methodology?

Current Economic Conditions

- Current economic conditions are the result of events that first started in the US in late 2006 with the decline in housing prices which led to various financial failures and crises in the US financial markets throughout 2007. The ensuing credit concerns led to a tightening of credit standards which by the last half of 2008 were impacting the wider economy and economies beyond the US. This global impact is clearly illustrated by the following table extracted from the Bank of Canada's January 2009 Monetary Policy Report Update.

Table 2
Projection for Global Economic Growth

	Share of real global GDP[a] (per cent)	Projected growth (per cent)[b]			
		2007	2008	2009	2010
United States	**22**	**2.0** *(2.0)*	**1.2** *(1.2)*	**-1.7** *(-0.1)*	**2.6** *(3.2)*
European Union	**20**	**2.7** *(2.7)*	**0.9** *(1.0)*	**-1.0** *(0.3)*	**2.1** *(3.0)*
Japan	**7**	**2.4** *(2.0)*	**0.0** *(0.5)*	**-1.7** *(0.6)*	**2.0** *(2.2)*
China and Asian NIEs[c]	**14**	**10.2** *(10.2)*	**7.5** *(8.1)*	**5.6** *(7.3)*	**6.9** *(7.5)*
Others	**37**	**6.6** *(6.6)*	**5.0** *(5.5)*	**2.7** *(4.5)*	**4.3** *(5.5)*
World	**100**	**5.0** *(5.0)*	**3.4** *(3.7)*	**1.1** *(2.8)*	**3.7** *(4.6)*

a. GDP shares are based on IMF estimates of the purchasing-power-parity (PPP) valuation of country GDPs for 2006. Source: IMF, *WEO Update*, January 2009.
b. Numbers in parentheses are projections from the October 2008 *Monetary Policy Report*.
c. NIEs are newly industrialized economies. These include Hong Kong (Special Administrative Region), South Korea, Taiwan (Province of China), and Singapore.
Source: Bank of Canada

- Like other countries, Canada has been impacted:
    - First, as noted by the Bank of Canada in its January 2009 Update, Canada has entered a recession. In response to this recessionary trend and the credit crunch that has accompanied the US financial crisis, the Bank of Canada has been reducing the Bank Rate. Between December 2007 and September 2008 the bank rate fell from 4.5% to 3.25% (i.e., 125 basis points). However, in response to the recently worsening economic conditions the Bank Rate has been reduced further in recent months and is currently (April 15, 2009) at 0.75%.

- Second, credit conditions have tightened for corporate borrowing as illustrated by the fact that despite the decline in the Bank Rate between December 4th, 2007 and January 16th, 2009 (i.e., from 4.5% to 1.75%) and a decline in the yield on long term Canada bonds (from 4.16% to 3.43%) over the same period, the long-term Corporate Bond rate actually increased[1].
- Third, the Consensus Economics' forecast for inflation in 2009 is 0.7%, well below the Bank of Canada's target of 2%[2].

Implications for the OEB's Cost of Capital Parameter Values

- The OEB's Cost of Capital Parameter values for 2009 are:
    - Short Term Debt – 1.33% is based on a 0.25% spread over the 3-month Bankers' Acceptance Rate. As a result, the change (from 4.47% in 2008) in the Board's short term rate is influenced by the fact short term interest rates have declined significantly since 2008.
    - Long Term Debt – 7.62% is based on the forecast Long Canada Bond rate plus the average spread for "A/BBB" rated Corporate Bonds. As a result, the change (from 6.1% 2008) in the Board's long-term rate is influenced by the decline in the Long Canada Bond rate for the current year, offset by the increase in the spread between Long Canada and "A/BBB" Corporate Bond rates.
    - Return on Equity – 8.01% is based on the Board's formula which is linked to the change in forecast Long Canada Bond rate. The decline from 8.57% in 2008 is a result of the reduction in the forecast Long Canada Bond rate for the current year.

<u>Question #2:</u> In the context of the current economic and financial conditions are the values produced by the Board's Cost of Capital methodology and the relationships between them reasonable? Why or why not?

- The Short Term Debt rate is driven by the fact that short term interest rates are currently at unprecedentedly low levels. Since the Board set this value based on January data, short term rates have continued to be low – driven by government policy aimed at both stimulating economic activity and relieving credit concerns as well as by the rate of inflation expected for 2009. This is

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[1] Bank Rates based on values reported by the Bank of Canada for December 5, 2007 and January 14, 2009. The Bank of Canada, Monetary Policy Report Update, January 2009 (page 6) reports an increase in the long-term Corporate Bond rate from 5.28% to 5.71% over this period. In comparison, combining the spreads implied by the OEB's 2008 and 2009 ROE and long-term debt values with the Long Canada Bond yields in effect at the time, the data used by the Board suggests that the long-term Corporate bond rate increased from approximately 5.7% to 7.5% between January 2008 and January 2009.

[2] Bank of Canada, Monetary Policy Report Update, January 2009, page 5 – Table 1

evident not only in the level of the Bank of Canada rate but also in current yields for 3-month Treasury Bills (0.85% as of April 2, 2009) and 3 month Bankers' Acceptance rates (0.53% as of April 1, 2009)[3]. Given these recent values the 1.33% does not appear to be unreasonably low.

- The forecast Long Canada Bond rate has declined from that used to set the 2008 Cost of Capital Parameters (i.e., from 4.456% to 3.714%). This decline is as much the result of the lower expectations regarding inflation as it is a result of lower short term interest rates. However, this decline has been more than offset by the increase in the spread between the Long Canada Bond rate and the rate for Corporate Bonds. VECC notes that in the case of BBB rated Corporate Bonds, the spread over the Long Canada Bond rate has varied in the past with economic conditions – increasing during the economic slowdowns experienced in the early 1990's and 2000's. This time the financial crisis accompanying the current recession has resulted in the spreads for "A" rated bonds increasing more than historically seen.

  It can be expected that as conditions return to normal (i.e., economies come out of recession, credit terms loosen and inflation increases) that the Long Canada Bond rate will increase and the spread for "A/BBB" Corporate bonds will decrease. This will likely lead to lower corporate borrowing rates overall. However, it is difficult to forecast when this will start to occur. The Bank of Canada is forecasting recovery will occur in the last half of 2009. However, some private forecasters are more pessimistic. Overall, the Board's methodology can be considered to produce a reasonable estimate for long-term Corporate Bond rates for 2009.

  VECC notes that the deemed long-term debt rate has a limited role in establishing an electricity distributors cost of capital. According to the Board's Cost of Capital Report it is only used when the borrowing in question is with an affiliate as follows:

  - It is used as the applicable rate for all variable-rate affiliate debt and for affiliate debt that is callable on demand.
  - It is used as a "limit" on the rate allowed for long-term debt contracted with an affiliate.

  Out of the 22 rebasing applications[4] for 2009 there are 6 six distributors that are expecting to issue new debt in 2009. However, in each case, the debt is expected to be issued to an arm's length 3rd party. What is interesting to note is that in all cases the forecast rate put forward by the distributor is less than the 7.62% deemed rate set by the Board. Reasons for this include plans by the distributors to borrow for shorter terms, in recognition of the current economic conditions, and plans by distributors to borrow through

[3] Source: Bank of Canada
[4] Originally 23 however West Perth Power has not completed its application.

Infrastructure Ontario where the quoted rates are significantly less. VECC also notes that during the oral portion of the recent Hydro One Networks' proceeding regarding its 2009-2010 transmission rate application the company testified that its most recent forecast as to its cost of long term debt for 2009 was 6.53%[5]. Similarly, in a recent Toronto Hydro-Electric proceeding regarding its 2009 cost of capital, the forecasted long-term borrowing rate proposed by the Distributor (and approved by the Board) was 7.25%.

As a result, it appears that the results of the Board's methodology may be overstating the long-term debt rate at which distributors can borrow for 2009. In VECC's view this is likely a function of a number of factors including:

- The fact that the forecast uses the spread for all corporate bonds (as prepared by PC Bond Analytics); whereas electricity distributors are a unique segment likely with a lower risk profile,
- Distributors frequently borrow from private lenders as opposed to going to market, and
- Many distributors have access to sources such as Infrastructure Ontario whose rates are linked to the cost of provincial borrowing.

- In VECC's view the ROE result is not unreasonable given the forecast Long Canada Bond rate of 3.714% for 2009. Indeed, as result of the 75% adjustment factor the 2009 ROE value of 8.01% represents a wider spread over the Long Canada Bond rate than was provided for in either the 2006 or 2008 allowed ROE values. Furthermore, with inflation forecast to be in the order of 0.7% for 2009, the real return included in the Long Canada Bond rate is higher that the return experienced by Real Return long term Canada bonds at any time over the last five years[6]. As a result, VECC does not believe that the ROE can be viewed as being too low. VECC also notes the 3.714% Long Canada Bond rate forecast for 2009 falls within the 3%-8% range that OPG's witness (Kathleen McShane) considered to be reasonable for purposes of applying the Board's formula[7].

- A question can also be posed as to whether the resulting relationship between the 2009 values for ROE and the long-term debt rate is inappropriate or unreasonable. In VECC's view the answer is no. As discussed above, the deemed long-term debt rate and ROE values are each reasonable given the current economic and financial conditions. Furthermore, as discussed more fully in CME's response[8], the results are not unprecedented. Indeed, there

[5] EB-2008-0272, Volume #5, page 31. While this was for Hydro One Networks' transmission business, the same borrowings rates are applicable to the company's distribution business.
[6] As reported by the Bank of Canada
[7] EB-2007-0905, Exhibit C2/Tab 1/Schedule 1, Page 110
[8] Pages 6-7

have been occasions where the approved cost of long-term debt exceeded the approved cost of equity.

<u>Question #3:</u> *What adjustments, if any, should be made to the Cost of Capital parameter values to compensate or correct for the current economic and financial conditions?*

- VECC does not believe that any adjustments are required to the Board's approach to Cost of Capital for Electricity Distributors at this time. In VECC's view the ROE values and short-term debt rate values are reasonable and fully explainable given current conditions.

- As noted earlier there is some question as to whether the value for the deemed cost of long-term debt is too high. Despite this concern, VECC's view is that there should be no attempt made to adjust the rate for 2009 for the following reasons:
    - First, as evidenced by the various 2009 rebasing applications as well as the Hydro One Networks and Toronto Hydro applications, there is no single value for the cost of long-term debt that is applicable to all electricity distributors. Rather there is a range of appropriate rates.
    - Second, the Board's formula cannot be expected to capture all the nuances of the economy and financial markets at any particular point in time. Rather it should be expected to produce reasonably acceptable results over time. At any point in time, the formula may not produce the "proper" for a particular utility's circumstance. However, if the Board were to seek to make adjustments in all such cases the formula's results would have very limited application.
    - Finally, there are no distributors who are rebasing this year and issuing new long-term debt to an affiliate. The only "rebasing" distributors that should be affected by this rate are 7 distributors who have existing debt with an affiliate that is not considered to be "long-term" or who propose to apply the Board's rate to their "deemed" debt that is not captured by existing borrowing. As result, the application of the current year's values will only influence a limited number of distributors (i.e., less than 1/3 of 2009 rebasing distributors are directly affected).

      VECC notes that distributors rebasing in 2010 or 2011 may seek (at that time) to use this deemed long-term rate to justify the rates for new long term affiliate debt that they contracted for in 2009. In VECC's view, justification of such rates should require these distributors to demonstrate that they made reasonable efforts to obtain the "best rate" available and the term of the debt contracted for was reasonable before the rate can be included in the approved cost of capital for the rebasing year. As a result, the 2009 deemed debt rate should not be determinative as to what their approved cost of debt will be.

<u>Question #4:</u> Going forward, should the Board change the timing of its Cost of Capital determination, for instance, by advancing that determination to November?

- VECC sees no reason for advancing the determination date for the Cost of Capital. The objective of the Board should be to determine test year values using the most current/up to date information. Determining the Cost of Capital parameters using January data allows this to occur, while permitting the findings to be included in Distributors' rates for May1st.

<u>*Question #5:*</u> *Are there other key issues that should be considered if the Board were to adjust any or all of the Cost of Capital parameter values produced by the application of its established formulaic methodology?*

- There are at least two key issues that the Board would need to consider if it were to seek to adjust any or all of the Cost of Capital parameter values produced by its current formulae.
    - First there is the critical question of process. As the Board noted in its April 14, 2009 Decision on Cost Eligibility:

      > "In addition, participants are advised that in the event that the Board determines that there is merit in considering adjustment to any of the Cost of Capital parameter values calculated by the Board's formulaic approaches for the 2009 rate year, the Board will initiate an appropriate process to consider those adjustments."

      Such a process would need to be properly constituted (e.g., parties provide evidence and opportunity provided for the testing of such evidence) and scoped (e.g., can the adjustments be limited to just the 2009 rebasing distributors or, if adjustments are warranted, what implication are there for distributors on IRM).
    - Second, VECC is concerned that the timing is such that any adjustment is likely to be made retroactively (i.e., affect 2009 rates after they are approved). Even, if the financial impacts are addressed through rate riders applicable to future consumption, there would be an element of retroactive ratemaking taking place. VECC submits that such results should only be permitted under exceptional circumstances. In VECC's view the current situation does not meet the necessary threshold.

Thank you for the opportunity to comment.

Yours truly,

Michael Buonaguro
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